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SUBJECT: Toy Factory Closure Raises Concern, Foreshadows More  
Difficulty for South China Manufacturing

REF: A) GUANGZHOU 291; B) GUANGZHOU 228; C) GUANGZHOU 498; D)  
GUANGZHOU 406; E) GUANGZHOU 398

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for internet publication.

[1](#)1. (SBU) Summary: Factory closures, especially those like Smart  
Union in the toy industry, have become topic one in south China,  
especially in the Pearl River Delta. Local governments are now  
scrambling to identify other factories that might be on the verge of  
shutting down; many of these have been in trouble for months, if not  
years, and their situation is not directly attributable to the  
spreading financial crisis. While some top tier firms are  
expanding, it seems likely that the longer the crisis persists, the  
worse the impact may be on the PRD. At this point, as elsewhere in  
country, job loss and the corresponding impact on social stability  
are being closely watched by the leadership. End summary.

One Week, Four High-Profile Factory Closures  
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[1](#)2. (U) Smart Union, a large Hong Kong-listed OEM toy manufacturer  
announced the closure of three Guangdong Province factories on  
October 15. Two of the factories were in Zhangmutou County of  
Dongguan City, a sprawling manufacturing community in the heart of  
the PRD. The company's other factory was located in Qingyuan, north  
of Guangzhou. The situation intensified a day later as workers  
gathered in front of the closed factories and local government  
offices to demand their unpaid wages. Images of the protesting  
workers aired on Hong Kong television broadcasts that evening and  
subsequently on news broadcasts around the world.

[1](#)3. (U) In addition to Smart Union, at least four other Hong  
Kong-listed manufacturing companies have also recently closed their  
doors and left as many as 8,600 unpaid workers in the last week.  
More than 1,500 laid-off workers protested outside a Shenzhen  
factory run by bankrupt small appliance maker BEP International.  
Another factory, watch maker Peace Mark, closed its doors on more  
than 500 workers in Longhua; media report that another 600 workers  
staged two days of sit-ins at an affiliated factory in Xixiang  
Township of Shenzhen. Managers from each closed factory are  
reported missing and suppliers to some of the factories are filing  
lawsuits for delinquent payments and damages.

Local Government Pays Workers, Assigns Blame  
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[1](#)4. (U) Although local governments have varied slightly in their

response to the closures, all have been eager to go after deadbeat employers and help the laid-off workers. Zhangmutou County announced October 17 it would pay wages of approximately 6,500 laid off Smart Union workers, with RMB 24 million (USD 3.5 million) in payments disbursed to the company's former employees on October 21. Local authorities have so far not been able to locate managers of the failed companies, an all too common situation in south China's labor-intensive manufacturing industries (ref A). Guangdong authorities have publicly accused companies of "premeditated" factory closures, with Vice Premier Zhang Dejiang, former Guangdong Party Secretary, reportedly ordering a full investigation after directing local and provincial authorities to cover the unpaid wages.

15. (U) Local governments have also stepped up efforts to identify other potentially insolvent factories by publishing the names and key information about those who have failed to pay their workers. On October 21, Shenzhen published a list of 30 companies that collectively owe their employees RMB 12 million (USD 1.75 million) in back salaries. Two thirds of the companies listed are located in Shenzhen's Longgang District and represent a variety of industries including plastics, apparel, real estate and furniture. Local press has reported that managers for most of the factories had fled after their information was published, and the government allocated money from its Wage Security Fund to help cover deficits. Dongguan and Zhongshan have also published similar lists in recent years.

Smart Union's Collapse - a Special Case...

16. (SBU) A senior executive for a top western toy company told

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SUBJECT: Toy Factory Clowuse"Gav),tknQ\$MQ regularly with all of its first-tier toy suppliers to discuss financial issues, plan new projects and improve safety and efficiency. Smart Union executives contacted the western firm 6-8 weeks before the factories closed to brief executives on its precarious financial situation. The two companies agreed on a plan to gradually reduce the buyer's exposure while contracting for new orders of lower-tech toy lines to help the supplier maintain cash flow and production capacity. The western firm began removing proprietary molds and tools shortly after the discussion with Smart Union executives, and completed the process two weeks before the factories closed.

17. (U) Southern Metropolis News (Nanfang Dushi Bao) published an in-depth analysis of the Smart Union collapse (the company may have owed as much as RMB 227 million, USD 33 million, to suppliers and workers) that identified many internal factors that contributed to the company's failure. Among internal causes, the paper claims Smart Union faced financial problems after losing RMB 67.5 million (almost USD 10 million) when its factory flooded in June 2008, destroying inventories and forcing a one-month closure. Rumors have also circulated that Smart Union lost RMB 269 million (USD 39 million) on failed investments in a major Chinese mining company, or possibly in the stock market. In addition, news reports said trading of the company's Hong Kong-listed shares were suspended following a fifteen month decline that ended with shares valued at RMB 0.099 (USD 0.014) each.

18. (SBU) According to the western toy company executive, Smart Union's failure was an unusual case because of the speed with which it went from having "cash-flow problems" to insolvency, unusual especially for a relatively large publicly-listed Hong Kong company with a well-known reputation as a profitable, first-tier toy maker that supplied top-tier overseas clients. He said most other recent toy industry failures were among smaller second- and third-tier firms, many of which were not publicly listed and would never qualify to supply a major buyer like his company. A Nike executive reinforced this notion, commenting to us recently that the factories closing down in the PRD are not part of the firm's supply chain.

19. (SBU) At the same time, the western toy company executive commented that his top suppliers are faring well despite all of the long term economic pressures, and several major toy firms are expanding within the PRD and in other areas of Guangdong Province as opportunities arise. The executive said he buys approximately 75

per cent of his toys from a select group of 15 top suppliers, spending almost USD 1 billion per year on those suppliers of a total USD 1.3 billion procurement budget. He pointed out that his company's earnings statement this week showed strong third quarter results and should not be affected by current economic conditions in south China, even as more small firms close and consolidate.

...and Part of a Trend  
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¶10. (SBU) As has been widely reported, many external factors also drove Smart Union's demise and are squeezing labor-intensive manufacturers in the PRD. Many of these are challenges that are to be expected in a maturing manufacturing sector, such as rising wages; higher raw material costs; appreciation of China's currency; tighter regulation, ranging from the new Labor Contract Law to stricter enforcement of environmental laws; and higher product safety standards after last year's toy recalls (ref B). Other factors include policies aimed directly at labor-intensive export manufacturers, like reductions in the value-added tax rebate (though apparently the Chinese government has recognized this problem and has increased VAT rebate for a variety of exports from textiles to furniture to toys). These are consistent with Guangdong's "double transfer" economic strategy aimed at pushing labor-intensive manufacturing and its workforce out of the PRD and into less developed areas of the province.

¶11. (SBU) These factors are largely independent of the global financial crisis, and there are today fewer media reports that attribute Smart Union's collapse to the global financial crisis. However, another key factor is slowing demand for China's exports. Manufacturers have been complaining about this for months, often arguing that U.S. buyers aren't willing to pay enough for their

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products (ref C). Smart Union's troubles started well before the most recent turmoil in global markets, but there are clearly expectations in the PRD that the market outlook for China's exporters will continue to deteriorate. Many observers are predicting that thousands of toy factories and other foreign-invested manufacturers will close by year's end (ref B).

Comment: Harbinger of a Crisis?  
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¶12. (SBU) The difficulties currently facing the PRD's labor-intensive manufacturing industries are by no means new or unexpected. However, the global financial crisis suggests that they may become worse than previously anticipated. With factories currently filling orders placed months ago, we have not yet begun to see the full impact of the crisis on south China's exporters.

¶13. (SBU) The answers to many questions about the future of the "world's factory floor" will remain unclear until that impact starts to emerge. What does this mean for Guangdong Party Secretary Wang Yang's "double transfer" vision? It appears that officials are already looking at ways to mitigate the forces pushing factories out of the PRD with new policies aimed at helping small and medium enterprises. In explaining the policy, many have cited the Chinese expression of "emptying the cage and changing the bird." (ref D) Now some of our contacts are talking about "expanding the cage and strengthening the bird" instead. What will the new approach look like?

¶14. (SBU) More importantly, how will laid-off workers react to their changed circumstances? This confronts PRD officials with a critical challenge: they are ready to compensate the unemployed to maintain stability, but will their efforts be enough?

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